8.01 Intangibles

Overview

Intangible assets refer to assets of a company which **lack physical substance** and provide economic benefits through the rights and privileges associated with their possession. They may be *identifiable* or *unidentifiable*. They also may be externally acquired (purchased at fair value) or internally developed (ASC 350). They come in 3 basic forms:

- Knowledge
- Legal rights & identifiable intangibles
- Goodwill (unidentifiable intangible)

Knowledge

Knowledge is developed by a process of **research and development (R&D)**.

- **Research** is aimed at the discovery of new knowledge that will result in a new product or process or a significant improvement to an existing product or process.
- **Development** is the conversion of that new knowledge into a plan or design for a new product or process.

Matching R&D costs to benefits is virtually impossible, since much of the work will result in failure, or the benefits are of indefinite value and duration. As a result of this tremendous uncertainty, R&D costs are **expensed** as incurred, in accordance with the conservatism principle.

The only **exception** is for the acquisition of fixed assets to be used in research. When such assets have possible **future benefits**, they should be **capitalized** initially, and the costs amortized into R&D over their useful life. Equipment purchased only for current R&D projects should be immediately expensed as R&D. (ASC 730)

Costs should **not** be treated as **R&D** when they are directly related to current revenue. The following costs are considered part of cost of sales and will be capitalized and recognized as appropriate:

- Research performed for others for a fee.
- Periodic design changes to existing products.
- Costs for setting up production of a commercially viable product.

Legal Rights & Identifiable Intangibles

These types of intangible assets include patents, copyrights, trademarks, franchises, and licenses.

Patents – Protection for product and process ideas resulting from R&D.

- The **capitalized cost** of a patent includes the **legal costs** of **obtaining** it and, if necessary, **successfully defending** it in court against infringement by other companies. If a legal defense of the patent is unsuccessful, all costs should be expensed since no legal benefit exists in that case.

- A patent that has been purchased from another party is capitalized at the purchase price.
- Patents have a maximum 20-year life but should be **amortized** over the **shorter of** the **useful** or **legal life**.
- Do not include research & development of product or process.

In general, the cost of the following other legal rights is determined similarly to patents: purchase prices to the extent the benefits were obtained from other parties plus legal expenditures associated with protecting them.

- **Copyright** – Protection of artistic works, including books, recordings, and computer software. The copyright period is for the life of the creator plus 70 years (or 95 years total for works made for hire), but the costs should be amortized over its useful life.
- **Trademark** – Exclusive use of an identifying name for a product or process. External acquisition costs are amortized over their useful life. Indefinite number of renewals for periods of 10 years each.
- **Franchise** – Operation of a business unit under contractual arrangements with another party.

After Acquisition

Finite Useful life Intangibles (subject to amortization) – Intangible assets with definite lives (ie, finite useful life) are amortized over their estimated useful lives, in accordance with the matching principle. When a range of lives is possible, the shortest alternative should be used, in accordance with the conservatism principle. The amount to be amortized is its cost minus residual value.

Similar to PP&E, these assets are evaluated **annually** to determine if events or conditions indicate a likelihood of **impairment**. If there is no indication, no further testing is required. If, however, events or conditions indicate it is likely that the asset is impaired, the **recoverability test** is applied.

- If the sum of the expected future net cash flows from the asset is less than the carrying amount of the asset, an impairment has occurred.
- The **impairment loss** is the amount by which the **carrying amount** of the asset is *greater than* the **fair value** of the asset.

In **determining** the **useful life**, consideration should be given to any legal limits on the existence of the right. *Patents and copyrights* have legal limits on their lives set by law. *Franchises* have legal limits based on the related contracts. To determine the useful lives**,** one must consider:

- The expected use of the asset by the entity
- Legal, regulatory, or contractual provisions that may limit the useful life
- The effects of obsolescence, competition, and other economic factors
- The expected maintenance expenditures required

There are three different **methods of amortization** that can be used. The method of amortization chosen should be the most conservative, meaning the one that reduces the carrying value of the intangible to the lowest amount (ie, highest amount of amortization).

- **Straight-line** – Costs are recognized equally over the useful life.
- **Units of sales** – Costs are allocated based on the sales to date as a percentage of estimated total sales.

- **Net realizable value** – Sufficient amortization is recorded to reduce the carrying value of the intangible to the estimated remaining future benefits.

Indefinite Useful Life Intangibles (not subject to amortization) – Intangible assets and goodwill with indefinite useful lives are NOT amortized, but rather are **tested** at least **annually** for **impairment**. If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life, it is considered to be indefinite.

Before testing an identifiable intangible with an indefinite useful life for impairment, an entity has the *option* to perform a qualitative analysis. If the qualitative analysis does not indicate impairment, no further testing is generally required until the next assessment anniversary date. There are several factors that may adversely affect the fair value of an intangible asset, indicating possible impairment:

- *Cost factors* – An increase in costs associated with the use of the intangible, such as raw materials or labor
- *Financial performance* – A decrease in cash flows, revenues, or earnings associated with the use of the intangible
- *Environment* – A change in the legal, regulatory, contractual, political, or business environment
- *Entity-specific events* – Changes in management or key personnel, strategy, or customers, and events like potential litigation or bankruptcy
- *Industry and market considerations* – An increase in competition, the effects of obsolescence, a change in demand, or a change in other economic factors
- *Macroeconomic conditions* – Changes in general economic conditions, limitations on the access to capital, fluctuations in foreign currency exchange rates, and other changes to the equity and credit markets

If the entity believes that one or more of these factors indicates that it is *more likely than not* that the intangible has been impaired, the intangible will be tested for impairment. Intangibles with an indefinite useful life, other than goodwill, are tested for impairment by comparing the carrying value of the asset to its fair value. As previously discussed, **fair value** is determined based on one of the following approaches **(MIC)**:

- **Market approach** – Uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or groups of assets and liabilities.
- **Income approach** – Converts expected future amounts, such as revenues or cash flows, to a single current amount applying present value concepts.
- **Cost approach** – Measures the amount that would be currently required to replace the service capacity of an asset.

If the asset is **impaired**, a **loss** is **recognized** in an amount equal to the excess of the asset's carrying value over its fair value. Subsequent **reversal** of a previously recognized impairment loss is **prohibited**.

Intangibles with indefinite lives (such as trademarks) are not amortized but are tested for impairment on an annual basis.